Deferred Compensation Plan
BOARD REPORT 11-02

Board of Deferred Compensation Administration
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Date: January 3, 2011

To: Board of Deferred Compensation Administration
From: Staff

Subject: Investment Menu and Trustee Services

Recommendation:
That the Board of Deferred Compensation Administration direct staff and the consultant to draft a Request for Proposal for a Fund Custodian.

Background:
At the August 17, 2010 meeting of the Board of Deferred Compensation Administration, the Board referred to the Investments Committee development of an implementation plan for its approved changes to the Plan's core investment menu. The Committee met on November 1, 2010, to consider a recommendation from staff concerning a range of implementation issues.

At this meeting the Committee discussed two threshold concepts impacting development of an implementation plan: (a) the question of whether an outside trustee/custodian should be used to provide certain investment-related trustee/custody services for Plan assets; and (b) the question of whether implementation of the new investment menu should occur all at once or be phased in gradually. The Committee requested that staff review these issues and then return to the full Board to present its findings.

Staff met with the consultant and Great-West Retirement Services on November 29, 2010, regarding this matter. As a result of that discussion, and related discussions on trust/custodial issues addressed in Board Report 11-01, the following findings have been reached.

A. OVERVIEW OF BOARD ACTIONS RELATIVE TO INVESTMENT MENU

In 2010 the Board completed its adoption of a new core investment menu for the Deferred Compensation Plan. The primary objective of this effort is to promote more effective asset allocation decisions among Plan participants. This objective will be met through two key steps:

(1) Reducing the number of options in the investment menu; and
(2) Branding investment options by asset class rather than investment manager.

Taking these two steps is consistent with the best practices of a number of large comparable plans, including the City of New York, State of California, and County of Los Angeles, which have already adopted investment models consistent with the one adopted by the Board.

The Board utilized the analysis of its Investments Committee and consultant in considering, over the course of several years and a series of meetings, each asset class component of an ideal investment menu. The Board has taken various actions to adopt the components of its investment menu, as well as the composition structures for each option.

The following table provides a summary of the investment menu categories, and their composition structures, as adopted by the Board:

Menu Offering	Composition Structure
DCP Deposit Savings Account	3 Providers of FDIC-Insured Deposit Savings Accounts (33% each)
DCP Stable Value Fund	1 Discretionary Stable Value Fund Manager (100%)
DCP Bond Fund	1 Active (50%), I Passive Manager (50%)
DCP Large-Cap Stock Fund	1 Passive Manager (100%)
DCP Mid-Cap Stock Fund	1 Passive (50%), 1 Active Value (25%), 1 Active Growth Manager (25%)
DCP Small-Cap Stock Fund	1 Passive (34%), 1 Active Value (33%), 1 Active Growth Manager (33%)
DCP International Fund	1 Developed Markets (65%), 1 Emerging Markets (17.5%), 1 Small-Cap Manager (17.5%)
DCP Ultra-Conservative Asset Allocation Fund	Blend of Core Asset Classes
DCP Conservative Asset Allocation Fund	Blend of Core Asset Classes
DCP Moderate Asset Allocation Fund	Blend of Core Asset Classes
DCP Aggressive Asset Allocation Fund	Blend of Core Asset Classes
DCP Ultra-Aggressive Asset Allocation Fund	Blend of Core Asset Classes
Self-Directed Brokerage Option	Various
Total Options: 13	Total Managers Needed: 16

At the November 1 meeting, the Committee considered staff's recommendation for a procurement schedule for each of the Plan's investment menu categories. However, in the process of having that discussion it was determined that two threshold concepts needed to be resolved. The first concerned whether a trustee/custodian should be used to provide investment-related trustee/custody services for Plan assets; and the second concerned whether implementation of the new investment menu should occur all at once or be phased in gradually.

B. INVESTMENT-RELATED TRUSTEE/CUSTODIAL SERVICES

As discussed in Board Report 11-01, defined contribution plans such as the City's Deferred Compensation Plan typically use an outside trustee or custodian to provide trustee/custodial services for Plan assets. The essential responsibility of a trustee/custodian is to meet the Federal requirement that Plan assets be held exclusively for the benefit of Plan participants and their beneficiaries. As indicated in that report, the City has assumed the role of self-trusteeing the Plan, and staff is recommending this function be delegated to an external provider (Wells Fargo) through the City's primary administrative services contract with Great-West Retirement Services.

Board Report 11-01 was focused exclusively on the manner in which the City's Plan currently and optimally meets the Federal trust requirement. The focus of this report is on whether an outside firm can or should be used to provide **investment-related** trustee/custodial services. Investment-related trustee/custodial services are not a required service relative to meeting Federal trust requirements.

As indicated in Board Report 11-01, there are certain types of trustee or custodial roles that can be used to not only satisfy the Federal trust requirement but provide other types of services:

Passive Trustee

A **"Passive Trustee"** is an entity acting exclusively in the capacity of meeting the Federal "Trust Requirement." The term "passive" is used because the trustee's duties are limited to this function only and are performed entirely at the direction of the Plan sponsor. A passive trustee is not providing an investment function as that concept is used in this report and therefore passive trustee services are not the subject of this report.

Fund Custodian

A **"Fund Custodian"** is an entity providing unitization services for separate account Plan assets in certain limited circumstances. Unitization services are an investment function that will be detailed later in this report.

Master Custodian

A **"Master Custodian"** is an entity providing unitization and/or other directed reporting/administrative services for all Plan assets. Master custodian services are an investment function that will be detailed later in this report.

C. INVESTMENT-RELATED TRUSTEE/CUSTODIAL DUTIES & NEW INVESTMENT MENU

Investment-related trustee/custodial services are relevant to implementing the Plan's new investment menu due to the potential for expanding the Plan's use of separate accounts (as opposed to mutual funds or commingled funds) as the underlying investment vehicles. To understand why requires understanding the differences between these products.

A mutual fund is a pool of assets belonging to a diverse array of investors. Investors place money into the mutual fund in exchange for shares of the fund. Mutual funds are typically available to both individual and retail investors. Mutual funds have certain reporting and mandatory filing/communications responsibilities to their investors.

A commingled fund (also known as a collective investment trust) operates in a similar manner. Investors place money into the commingled fund in exchange for shares or "units" of the fund. Commingled funds are typically only offered to institutional investors. Consequently, commingled funds have less stringent regulatory and communications responsibilities because they are not targeted at individual investors.

Separate accounts are pools of money managed by an investment manager. Assets in the separate account are owned exclusively by "the plan," and unlike mutual funds and collective investment trusts are not commingled with funds from other investors. In the retirement world, separate accounts have in the past been more common in the defined benefit arena where, for example, a pension fund might contract with an investment firm to manage a portfolio with a specific mandate. Because these pension fund investments tend to be large and the administrative/communication requirements small, pricing for separate accounts is generally lower than for mutual funds, and more commensurate with the costs of commingled funds.

As defined contribution plans have grown larger, they have begun utilizing separate accounts to a greater extent. This is so they can take advantage of the more favorable pricing offered. A separate account, however, merely holds a plan's aggregated investments in a particular investment option. In a defined contribution plan environment, the account would thus still need to be carved into smaller units (i.e. "unitized") to apportion each participant's share of the account.

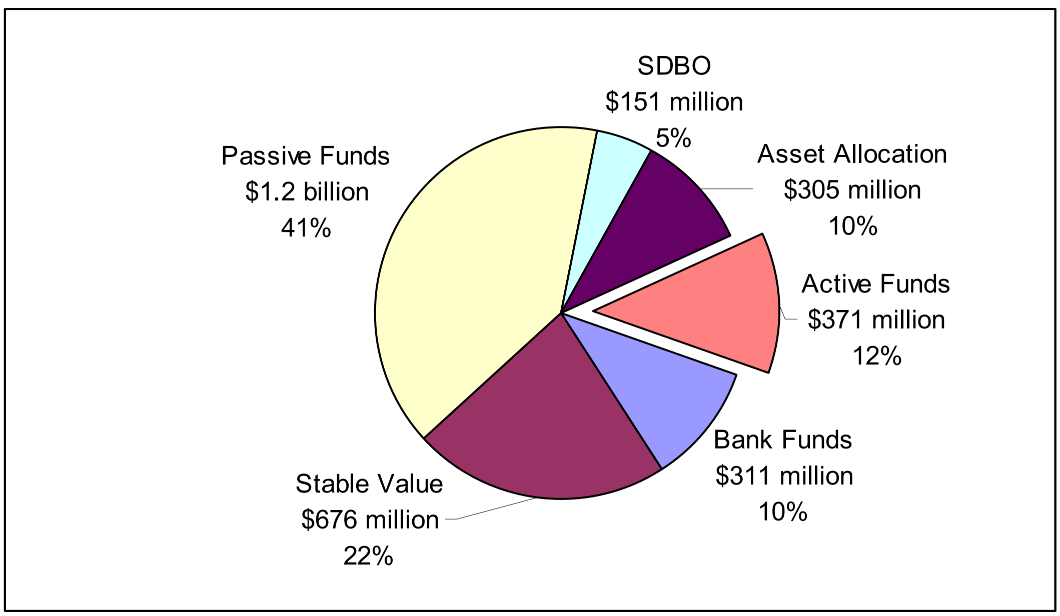
For example, if an asset pool contained $100,000, a unit value of $2 might be established, meaning there would be 50,000 "units" within that pool that would be apportioned between all investors in the pool pro-rata. The number of units one owned would depend on how much of that $100,000 belonged to a given individual. Someone who invested $100 would own a smaller number of units, and someone who invested $10,000 would own a larger number of units.

In many large defined contribution plans which have gravitated towards using separate accounts (e.g. the City of New York and County of Los Angeles) an outside "Master

Custodian" is used to provide the unitization function as well as broader responsibilities applying to the entire plan, including certain reporting functions. Master Custodian duties come at a cost, typically expressed in basis points assessed against all Plan assets. As an example, if a Plan had $1 billion in assets, and hired a Master Custodian to provide expanded trustee/custodial duties at a cost of 1 basis point, the cost to the Plan would be $1 million.

In discussing this at length with Great-West Retirement Services and the Plan's consultant, it appears that the functions performed by a Master Custodian would be, for most Plan assets, duplicative and unnecessary, or in all likelihood more expensive than the equivalent service provided by Great-West. For example, Great-West currently provides the unitization service as a recordkeeping duty for the Plan's five asset allocation funds at a cost of $6,000 per fund per year, or $30,000 in total annually. By contrast, an asset based fee of 1 basis point assessed against the current asset allocation funds' total of $305 million would cost $305,000. If the City were to have Great-West perform the unitization function for its new options, the cost would be slightly higher at $7,000 per blended fund per year, with an additional setup fee of $10,000 per fund. This cost should still be significantly less than the cost of using a Master Custodian.

To further illustrate this point, the chart below provides a snapshot of current Plan assets as they would look if they were immediately mapped to the Board's new investment menu structure. Only the "Active Funds" slice of the pie chart represents an area where the services performed by a Master Custodian would be needed. The other segments do not require unitization or, as in the case of the Asset Allocation funds, could have unitization performed much more cost-effectively be Great-West.



Given this, it appears that the most cost-effective, efficient and logical course of action would be to attempt to procure the services of a "Fund Custodian." A "Fund Custodian would have the limited responsibility of providing unitization only for those separate accounts procured by the Plan which could not generate their own unit values or would do so at a more expensive cost than that charged by the Fund Custodian. (Although historically separate account providers have not provided unitization for their accounts, the City can still ask potential providers about their capabilities in this area.)

E. Deemed IRA

One other issue relating to the use of outside trustee/custodial investment services concerns the use of these services in relation to administering a "Deemed IRA." The City's Plan has the authority under the Administrative Code to offer a "Deemed IRA," i.e. an Individual Retirement Account that is sponsored by the Plan. Such an IRA could be either a Traditional, Roth, or both. Although the legal authority for offering a Deemed IRA exists, the City's Plan has not yet moved forward on offering it because a range of complexities needs to be addressed. One of those complexities concerns whether certain unique trustee duties would need to be performed and how they would be provided.

Staff is currently in the process of investigating this issue with Great-West but has not completed its review. Depending on the results of that review, a Request for Proposal (RFP) for Fund Custodian duties might be partnered with an RFP for services related to administering a Deemed IRA. This can be addressed in the process of drafting the RFP and will likely be brought back to the Board for separate review prior to completion of the RFP document.

F. Implementation Schedule

Staff previously proposed to the Investments Committee a schedule for implementing the new investment menu. Because of the significant scope of the project, and the considerable time, resources, and costs involved with conducting procurement processes, staff looked for areas where existing options could be used and procurement deferred. Staff also drafted a long-range plan for conducting procurement on a regular schedule in which not all options would be competitively searched at the same time.

In the Committee's discussion, however, the question arose as to whether implementation of the new menu (whether in whole or gradually) could proceed immediately and without having to wait until procurement processes were conducted for all of the options. Before addressing this, however, the Committee felt it was important to resolve the issue about trustee services with the full Board.

Under the assumption that those issues would be resolved through adoption of staff's recommendation, staff recommends that the implementation schedule issue be either referred back to the Investments Committee for further development or addressed separately in a subsequent report to the full Board.

Submitted by: ______________________________
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